

1936.¹⁵ Still today, the Commission's USOA defines "original cost" as of "the time when it was first dedicated to use by a regulated telecommunications entity, whether the [current] accounting company or by predecessors." See 47 C.F.R. § 32.9000 (1992) (Glossary Of Terms For The Uniform System Of Accounts).

The Commission has thus made clear that, for purposes of determining excess acquisition costs, dedication to the public use occurs at the time the plant in question was put into regulated service. See Rate Base and Net Income of Dominant Carriers, 69 Rad. Reg.2d (P&F) 1567, 1568 n.3 (1991) ("a premium, or a plant acquisition adjustment, results from a carrier paying an amount for plant above that plant's net original cost at the time it was put into regulated service less depreciation reserve") (emphasis added). Other federal and state regulators using "original cost" methodology have

¹⁵ American Tel. & Tel. Co. v. United States, 299 U.S. 232, 238 (1936). The USOA created a separate account, called the plant acquisition adjustment account, to record the difference between the amount of money or other consideration actually paid for telephone plant acquired, plus preliminary expenses incurred in connection with the acquisition, and the net original cost of the plant to the entity first dedicating it to the public use. Id. The Commission's definition of original cost has thus always recognized the inappropriateness of looking to the historical cost of plant prior to regulation, which is the point at which that dedication occurs.

demonstrated further that dedication to the public use, in this context, contemplates utility-type regulation.¹⁶

The NPRM thus fatally ignores the distinct regulatory history of the cable industry when it assumes that the original cost of cable systems can lawfully be viewed as their initial cost of construction. While local regulation of cable rates existed in various forms and degrees before the onset of the Cable Act of 1984, that act had both the fundamental intent and the sweeping effect of deregulating cable rates nationwide.¹⁷ Cost-of-Service NPRM at ¶ 22.

¹⁶ See, e.g., Pennsylvania Pub. Util. Comm'n v. Scranton, 1974 Pa. PUC LEXIS 68 (July 9, 1974) (property is dedicated to a public use where it is "used or useful in rendering a public utility service and has been part of a public utility's rate base"); Hackensack Water Co. v. Borough of Old Tappan, 390 A.2d 122, 126 (N.J. Sup. Ct. 1978) ("original cost is the cost of the property to the first person who devoted the property to utility service."); Ohio Suburban Water Co. v. Ohio Pub. Util. Comm'n, 402 N.E.2d 539 (Ohio Sup. Ct. 1979) (original cost of utility property determined when first dedicated to public use) cert. denied, 499 U.S. 876 (1980); and Heater Utilities, Inc., Docket No. W-274, Sub. 4 (N.C. Dec. 21, 1971) (original cost of water company's equipment determined as of the time plant was first devoted to public utility use).

¹⁷ The fundamental purpose of the 1984 Cable Act, as facilitated and affirmatively embraced by the Commission's subsequent "effective competition" definition, was to deregulate cable rates in virtually every market as of December 30, 1986. See S. Rep. No. 67, 98th Cong., 1st Sess. 22 (1983); Effective Competition Report and Order, 58 Rad. Reg.2d (P & F) 1 (1985), modified on recon., 104 F.C.C.2d 386 (1986). The Senate Report underlying the Cable Act of 1992 specifically decried the fact that, under the 1984 Cable Act, cable rates were indeed deregulated for 97 percent of all cable systems. See S. Rep. No. 92, 102d Cong., 2d Sess. 4 (1992).

Indeed, it was Congress's concern over the unregulated status of rates under the Cable Act of 1984 that, in large part, spurred the enactment of the Cable Act of 1992.¹⁸ Thus, even if cable systems were arguably dedicated to the public use before the Cable Act of 1984, they were effectively "undedicated" for rate regulation purposes ever since.¹⁹

It is the Cable Act of 1992 that has now given rise, in the Commission's own words, to the impending "transition of the [cable] industry from a non-regulated to a regulated environment." The pervasive, utility-type regulation mandated by the Cable Act of 1992 is without precedent in the history of the cable industry. Rationally applying Commission precedent and general public utility law to the cable industry thus requires that "dedication to the public use" be recognized only as of the date of rate regulation under the Cable Act of 1992 and, accordingly, that the "original cost" of cable plant be based on the net acquisition cost reflected on cable systems' books at that time.

Even if the Commission were to deem cable systems to have been dedicated to public use prior to the Cable Act of

¹⁸ See House Report at 30.

¹⁹ The entire issue of rate base valuation arises, after all, only when an industry is rate regulated and its return on investment thereby becomes a matter of public determination.

1984 so that "original cost" harkens back to that pre-1984 era, such a rule should not apply to those cable systems which, through sale of assets or otherwise, were acquired at arm's length during the period of deregulation between the Cable Act of 1984 and the Cable Act of 1992. During this period, there was no dedication to public use insofar as rates and pricing were concerned, and indeed issues with respect to utility-type rate regulation were irrelevant to any investment evaluation or analysis. By definition, purchases during this time were made from a non-utility seller as the property would not have been utilized at the time of the sale in providing services subject to utility-type regulation. "Original cost" methodology itself recognizes that there would be no "excess" acquisition costs under such circumstances and that, consequently, all acquisition costs are deemed to constitute "original cost." As explained by a leading commentator on public utility law:

In cases where used property is purchased from non-utility sellers, no acquisition adjustment is usually involved, since the property has not previously been utilized in providing utility services. In these cases, net original cost is the purchase price paid by the acquiring utility.

Charles F. Phillips, Jr., Accounting for Public Utilities
§ 4.04[3] (1985) (emphasis added).²⁰ Thus, a fair
application of original cost methodology must allow the full
cost of cable systems acquired in the absence of rate
regulation to be included within their initial rate base.

2. "Original Cost" Jurisprudence Recognizes
The Appropriateness Of Including The
Entire Purchase Price Of An Asset In The
Rate Base Where The Public Interest
Warrants

Not only would regulatory law allow cable operators to
use acquisition costs for rate base purposes, but FCC policy
would as well. Past cable acquisitions simply do not give
rise to the traditional concerns warranting disallowance of
"excess" acquisition costs. There is no reason to assume
that cable system acquisitions predating rate regulation were
not negotiated in the normal course of business. This is
true per force where the seller and purchaser were unrelated
to one another and thus negotiated at arm's length. Even
where -- unlike in the newly regulated cable industry -- the
rationale underlying the "original cost" approach does apply,
moreover, the courts and regulatory agencies have tempered
this methodology with reason and equity.

²⁰ See, e.g., Virginia Electric & Power Co., 38 F.P.C.
487 (1967) and Black Hill's Power & Light Co., 40 F.P.C. 166
(1968) (acquisition prices of electricity plants acquired
from non-utilities constituted original cost because plants
had not previously been dedicated to public use).

The basic rationale for disallowance of excess acquisition costs is to preclude utilities from inflating their rate base by purchasing assets at prices greater than market value.²¹ This problem does not arise, however, where acquisitions reflect an arm's length, free market transaction.²² The purchase price in unregulated industries would hardly be set at artificial levels for the purpose of inflating any rate base.

As the Commission has recognized, when a carrier buys a required asset from another carrier at a price equal to or lower than that it could obtain from other sources, both the carrier and ratepayers benefit. Thus, the FCC will allow

²¹ See Montana Power Co. v. FERC, 599 F.2d 295, 300 (9th Cir. 1979) (citing United Gas Pipe Line Co., 25 F.P.C. 26, 64 (1961)). See also California Oregon Power Co. v. FPC, 150 F.2d 25, 28 (9th Cir. 1945) (disallowing a portion of acquisition costs to protect "the public against artificially inflated investment costs on the basis of which utility companies assert the right to a return") (emphasis added) cert. denied, 326 U.S. 781 (1946); American Television Relay, 65 F.C.C.2d 385, 393 (1977) ("[w]ithout this rule, repeated sales of the same property could, and most likely would, result in even larger rate bases, thus requiring higher rates for service to achieve the same rate of return."); Accounting for Public Utilities § 4.04[2] (explaining that separate accounting for acquisition adjustments was necessitated by abuses in the utility industry mergers of the 1920s and 1930s, which enabled "commonly owned utilities . . . to inflate their rate bases through transactions that lacked economic substance."); and California Water & Tel. Co., Decision No. 70418, Application No. 48170 (Mar. 8, 1966).

²² The related traditional fear that ratepayers would pay for the same asset over and over again if two utilities could pass assets back and forth, and in each case "step up" their value, is likewise inapposite where, as here, we are addressing the starting point of rate regulation.

carriers, even when both seller and purchaser are already subject to regulation, to advance arguments as to why any "excess" acquisition cost should be placed in the rate base.²³ With a proper showing, the entire purchase price may be included in the rate base. See Rate Base And Net Income of Dominant Carriers, 4 FCC Rcd 1697, 1705 (1989); see also Illinois Bell v. FCC, 911 F.2d 776 (D.C. Cir. 1990) and Rate Base And Net Income of Dominant Carriers Rad. Reg.2d (P&F) 1567 (1991).

Other regulatory authorities have likewise recognized that where the purchase price of property acquired by a regulated entity is the result of arm's length bargaining with an unaffiliated seller, the entire acquisition cost is properly allowed rate base treatment. The view of the Louisiana Public Utility Commission is typical:

Money is prudently invested, even though it is in excess of the original cost of the property purchased, if the excess of purchase price over original cost was paid as the result of arm's-length bargaining between nonassociated buyer and seller²⁴

²³ Section 32.2000(b)(1) of the Commission's Rules automatically allows small acquisitions of plant to be valued at the agreed-upon purchase price. 47 C.F.R. § 32.2000(b)(1).

²⁴ Louisiana Power & Light, 65 P.U.R. (NS) 23 (1946). See also Arlington County v. Virginia Electric Power Co., 87 S.E.2d 139 (Va. Sup. Ct. 1955) (Virginia Supreme Court of Appeals affirmed the decision of the State Corporation
(continued...)

Viacom strongly urges the FCC to recognize that -- at least in this transition from an unregulated environment -- there exists no sound reason in policy not to treat "real costs" (i.e., the true value of the assets as reflected by the purchase price) as valid expenditures and properly include them in a cable operator's rate base. Inclusion of such costs is in the public interest because it will promote a healthy, vibrant cable industry, while at the same time ensuring that cable rates do not exceed proper levels. Any other treatment would ignore prior investor expectations and ultimately harm consumers by frustrating the Cable Act's goal

²⁴(...continued)
Commission to allow rate base treatment for amounts paid in excess of original cost when first devoted to public use because the acquisition was result of arm's length bargaining); Southwestern Bell Tel. Co. v. Kansas State Corp. Comm., 386 P.2d 515 (Kan. Sup. Ct. 1963) (where the reasonableness of price paid by utility for telephone exchange property is not questioned, the entire purchase price should be included in rate base); Acme Brick Co. v. Arkansas Pub. Serv. Comm'n, 299 S.W.2d 208 (Ark. Sup. Ct. 1957) (amount in excess of original cost, paid by gas company in acquiring plant was properly included in the rate base where the purchase was found to have been made at arm's length); Washington Power Co., 59 P.U.R.3d 86 (1965) (acquisition adjustment amount allowed in rate base where electric company purchased, in an arm's-length transaction, a portion of power project); and Alabama Gas Corp., 105 P.U.R.4th 423 (1989) (utility granted rate base allowance equal to the full fair-market value of acquired utility assets, even though fair market value exceeded the book value of the acquired assets because, among other things, the purchase was the result of an arm's length transaction).

of ensuring optimal investment in system improvements and programming service.²⁵

Apparently recognizing that the arm's length acquisition of cable systems prior to rate regulation renders inapposite the traditional rationale for disallowing "excess" acquisition costs, the Commission invokes as its own rationale in this context the "presumption" that acquisition costs above net historical cost "reflect an expectation of monopoly earnings." See Cost-of-Service NPRM at ¶ 36. As demonstrated in Section II(B) below, it is both analytically and empirically unsupportable to presume that monopoly rents exclusively, or even largely, explain the premiums paid above net historical cost (or even above replacement costs) for plant in a dynamic, rapidly growing industry. Furthermore, as explained immediately below, disallowance based on this assumption, which willy-nilly ignores all elements other than a capitalization of monopoly rents as the reason for premiums paid above historical cost, would so systematically deny cable operators their reasonable, investment-backed expectations as to amount to an unconstitutional confiscation.

²⁵

See supra note 6 and accompanying text.

3. Categorically Excluding From The Rate Base Costs In Excess Of Net Historical Costs Would Improperly Penalize The Cable Industry, As Well As The Viewing Public It Serves, And Constitute An Unconstitutional Confiscation

Denying cable operators any return on their investment in cable systems in excess of net historical cost would seriously undermine the constitutionality of the Commission's entire rate regulation scheme. Viacom recognizes that the Commission retains substantial discretion in determining a constitutionally adequate return on investment, including whether a given investment was prudent and legitimate. However, to categorically deny all cable operators any return on the intangibles and other market premiums paid for a cable system prior to rate regulation would not comport with any reasonable notion of fundamental fairness or "just and reasonable compensation" as mandated by the Constitution.

Although it might be constitutionally permissible to disallow prudent investments where regulated entities know of the risks of disallowance -- and thus the price of the asset is set accordingly -- this is hardly the situation here.²⁶

²⁶ In its 1990 Rate Prescription Order, the Commission justified its disallowance of an Ameritech's rate base item on exactly that basis, noting that "[i]nvestors are presumably aware of our ratemaking procedures, including our treatment of plant that is not automatically included in the rate base, and take these procedures into account in establishing the price of the stock." 5 FCC Rcd 7507, 7521 (1990), recon. denied and clarified, 6 FCC Rcd 7193 (1991), (continued...)

At least in the period after 1984 and before the legislative drive culminating in the Cable Act of 1992 gained real momentum, no acquiring cable systems at prevailing market prices could reasonably have been expected to account for the risk that its acquisition costs would be categorically disallowed to the extent they exceeded the (widely variable) level of undepreciated original plant cost on the books at the time of the acquisition. It would amount to historical revisionism in the extreme to allow the subsequent enactment of the Cable Act of 1992 to suddenly render the reasonable, investment-backed expectations underlying prior cable acquisitions to be "unreasonable" or "imprudent." Indeed, this would be just the sort of arbitrary governmental denial of reasonable expectations that creates an unconstitutional taking. See, e.g., Williamson Planning Comm'n v. Hamilton Bank, 473 U.S. 172, 190-91 (1985). Commissioner Duggan suggested as much in lamenting the ex post facto nature of the NPRM in this regard: "We have an obligation to define

²⁶(...continued)
aff'd, Illinois Bell v. FCC, 72 Rad. Reg.2d (P & F) 530 (D.C. Cir. 1993). See also Duquesne Light Co. v. Barasch, 488 U.S. 299; and Williston Basin Interstate Pipeline Co. v. FERC, 931 F.2d 948, 954 n.6 ("Duquesne assumed that regulators would use the rate of return to compensate utilities for the additional risk that follows from denying recovery for prudent investment."). But see A. Kolbe and W. Tye, The Fair Allowed Rate of Return With Regulatory Risk, 1992 Res. L. & Econ. 129, 142-50, questioning whether, as a practical matter, a rate of return component can truly compensate for such disallowances.

what is reasonable in a way that does not amount to ex post facto, retroactive punishment." Open Meeting of the Federal Communications Commission, July 15, 1993 (Statement of Commissioner Ervin S. Duggan)

Disallowing these so-called "excess" acquisition costs would so greatly undervalue many cable systems' rate base that cost-of-service showings would be completely unavailing. The Act certainly does not compel this result. The policy of the Act is to replicate competitive rates, i.e., rates which allow for the recovery of costs. It is not the policy of the Act to "punish" cable operators by forcing rates to levels which fail to cover acquisition costs that do not clearly constitute a capitalization of monopoly rents.

As explained in Section II(B) below, moreover, the legitimate market value which cable operators pay in excess of net historical cost when acquiring a cable system often represents a substantial portion of the acquisition price. Excluding that portion of the investment from the cable system's rate base would make it impossible as a practical matter to recover a reasonable return on the investment, even if the Commission were to allow a rate of return far in excess of the range it has proposed.²⁷ See Cost-of-Service

²⁷ In Duquesne, 488 U.S. at 305, the Supreme Court reaffirmed the principle that a just and reasonable rate depends "to some extent on what is a fair rate of return given the risks under a particular rate-setting system, and
(continued...)

NPRM at ¶ 52. Thus, it would be unlikely that cost-of-service showings would permit cable operators to substantiate rates significantly greater than the presumably noncompensatory rates allowed under the benchmark/price cap mechanism itself.

The Commission is, of course, well versed in the constitutional constraints on rate regulation:

Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being employed to render service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of [the Constitution].

Bluefield Water Works & Improvement Co. v. Public Serv.

Comm'n, 262 U.S. 679, 690 (1923). See also Federal Power

Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944)

(return on equity must be "sufficient to assure confidence in the financial integrity of the enterprise" so that its credit is maintained and capital may continue to be attracted);

Permian Basin Area Rate Cases, 390 U.S. 747, 792 (1968) (rate

²⁷(...continued)
on the amount of capital upon which the investors are entitled to earn that return." Duquesne confirms that adverse regulatory changes implicating a utility's return on investment would "have no constitutional effect on the utility's property if they are compensated by countervailing factors in another element." Id. at 314 (emphasis added). Most significantly, in a concurring opinion, Justice Scalia noted that the Constitution requires that all prudent investments, even those disallowed, be considered in assessing the ultimate fairness of the permitted return. Id. at 317.

must "maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed").

Rate regulated entities thus must be allowed to "earn enough revenue not only to cover operating expenses, but also to pay for the capital costs of doing business, including service on debt and dividends on stock." U.S. v. FCC, 707 F.2d 610, 612 (D.C. Cir. 1983). See also D.C. Transit System v. Washington Metro Area Transportation Comm'n, 350 F.2d 753, 778 (D.C. Cir. 1965) ("rate fixed without particularized reference to [debt service and other] needs does not satisfy any standard of rate making of which we are aware").

The Commission only recently reaffirmed its clear understanding of the constitutional command that regulated cable rates be just and reasonable. Memorandum Opinion and Order, supra, at ¶¶ 14-15. The Commission reiterated that "[t]o the extent that the Commission's primary method of competitive benchmarks and price caps may be inadequate when applied in individual circumstances, the Commission has given assurance that it will permit cable operators an opportunity to demonstrate the reasonableness of higher rates based on costs" Id. at ¶ 15. The Commission thus recognizes that its cost-of-service standards -- and indeed its entire cable rate regulation scheme -- are, of course, ultimately constrained by the Fifth Amendment's mandate that rates not

be set at confiscatory levels, i.e., that they provide a just and reasonable return on investment.

Thus, in allowing cable operators to substantiate cost-justified rates in excess of benchmark levels, the cost-of-service approach serves not only as a "backstop" for cable operators. It also serves as the Commission's "backstop" for the asserted constitutionality of the Commission's benchmark approach and overall rate regulation scheme as well. This "backstop" crumbles, however, to the extent that cost-of-service standards have the systematic effect of driving permitted rates back toward the benchmark levels even for those whose costs exceed those levels. A cost-of-service alternative that, as a practical matter, amounts to no real alternative at all for many cable operators thus utterly fails in its role as a constitutional "backstop" for the Commission's comprehensive rate regulation scheme.

In sum, historical cost is a concept uniquely applicable to industries already under regulation. In those circumstances, all investment decisions are undertaken with a recognition of the governing regulations. This is not the case when an industry has been unregulated. To use historical costs for the transition into regulation is both irrational and unjust. It would deny cable operators any return on substantial, real costs legitimately incurred, thereby undermining and ignoring reasonable investor

expectations and possibly damaging the financial soundness of significant segments of the industry. Certainly such a result serves no one's best interest, neither operator nor subscriber.

- B. Rather Than Rely On Economically
Meaningless Historical Costs, The
Commission Should Establish Initial Cable
Rate Bases According To Competitive
Market Values In Order To Produce Rates
Replicating Competition In A Growing
Industry

The Commission's proposed "original cost" methodology is not only, as shown above, inappropriate for initial rate base valuation as a matter of law and policy, but it is also unfounded as a matter of economics. As the attached economic study prepared by Kolbe and Vitka of The Brattle Group indicates, the FCC's proposed use of historical cost is fundamentally ill-equipped to serve the Commission's stated objective that its cost-of-service standards produce rates similar to those produced under competition. Indeed, several economic factors indicate that net historical cost is especially ill-suited to valuing the rate base of a growing industry such as cable.

In growing industries, competitive markets will value assets well above historical costs -- indeed, even well above replacement costs. As a result, purchase prices will predictably exceed both historical and replacement cost

levels. Thus, it is irrational to assume that the difference between the acquisition price and the historical value of the assets in a growing industry represents the capitalization of monopoly rents.

At the same time, it is impossible to establish that no portion of that difference reflects someone's view of "monopoly rents." The Kolbe/Vitka Study, therefore, recommends that the Commission value cable plant at its competitive market value, which is equivalent to the actual market value of the assets less any quantifiable capitalized monopoly profits. As detailed below, the Kolbe Study concludes that, while monopoly rents are difficult to prove or determine precisely, the market has made clear that they could not have represented even as much as 10 percent of the preregulation market value of cable assets.

1. Assets In A Growing Industry
Are Worth Substantially More
Than Historical Or Replacement
Costs Even In Vigorously
Competitive Markets

Use of the Commission's proposed "original cost" methodology for establishing a cable system's initial rate base will fail to produce competitive rates, as the Kolbe/Vitka Study demonstrates, for the simple reason that historical costs have little bearing on present asset values and, in turn, on the rates presently charged by a firm under

competitive conditions. Competitive markets value assets at levels far greater than the historical cost recorded when an asset is acquired -- and, for growing industries, at levels far greater than replacement costs.

The Kolbe/Vitka Study explains the three essential reasons why competitive market value exceeds historical costs. First, the value of assets in a competitive market increases with inflation, while net historical cost does not change with inflation. Second, the value of assets in a competitive market is not inherently fixed, but rather varies based on such external factors as technological change affecting the market and relative productivity during the years of operation. Third, the value of assets in new or expanding industries, in particular, will be determined not only by the value of the assets themselves, but also by the value of the opportunities that derive from a firm's presence in a rapidly expanding industry.²⁸ In such an industry, technological innovations and anticipated new products offer an expanding array of consumer services, which can be expected to generate increased profits. These growth "options" are highly valued because they confer the right,

²⁸ Genuine competition, unlike traditional rate regulation, encourages firms to innovate and to improve service in order to grow and increase profits. As the Kolbe Study explains, competition does this by offering firms above-normal profits in an expanding market and below-normal profits in a shrinking market.

although not the obligation, to invest in and exploit new and developing opportunities. A firm can take advantage of expected new investment opportunities, but it can also refrain from doing so and withhold further investment if government regulations, market developments, or slowed company or industry growth so dictate. Therefore, as Dr. Kolbe explains, assets in rapidly growing competitive industries are worth more than even replacement costs.

Indeed, this fact explains why industries expand under competition. Growing firms attract capital because new assets are worth more than the cost of building those assets, while old assets remain worth more than replacement cost. Conversely, in a contracting industry, new assets are worth less than the cost of building the assets, and old assets are worth less than replacement cost.

Moreover, even in industries that are not characterized by rapid growth, an asset's value might depend on associated administrative and marketing economies of scale. A cable operator that acquires systems in adjacent markets, for example, would rationally pay a premium over net replacement cost to gain the benefit of cost-saving economies of scale.

2. Premiums Paid For Cable Systems
Above Historical Costs Cannot
Rationally Be Assumed To
Reflect Monopoly Rents

As assets in an unregulated, competitive market are valued above historical costs, it is not surprising that acquisition prices for cable systems in the past have exceeded original construction costs. The difference between the historical and market value of cable systems cannot, therefore, simply be assumed to constitute capitalized monopoly rents. Indeed, the Kolbe/Vitka Study demonstrates that acquisition prices of cable systems prior to regulation could not reasonably be assumed to have exceeded their competitive market value by any more than 10 percent.

As the Kolbe/Vitka Study explains, the natural starting point for valuing the rate base of a cable system would be its actual pre-regulation market value. However, the Commission has expressed concern that this value may include capitalized monopoly rents. While that is not easily demonstrated, the Kolbe/Vitka Study accordingly attempts to establish a competitive market value for cable assets, which would exclude from the actual market value any quantifiable capitalized monopoly profit.

In order to determine competitive market value, the Study attempted to quantify capitalized monopoly rents in two ways. Using transactional data, it first compared the sale

price of various cable systems to the price paid for systems found to be subject to competition or otherwise characterized as free of monopoly profits. The Study finds that this approach suffers from several significant defects, however, such as the difficulty of identifying a reliable control group and idiosyncratic variations in transaction prices. Thus, the Kolbe/Vitka Study concludes that this method is not feasible -- at least not without the collection of extensive detailed information about each of the transactions.

The second and more successful method Kolbe and Vitka used to quantify monopoly profits was an "event study", in which they examined changes in the market values of publicly-traded cable companies in response to the onset of rate regulation. This approach submits that, if monopoly profits constituted part of the value of unregulated cable companies and rate regulation signalled the end of such profits, then the stock market value of the companies should fall by the amount of the capitalized monopoly profits. This amount could then be applied to the valuation of assets so as to enable the Commission to adjust cable starting rate bases to account for any capitalized monopoly profits which may otherwise be reflected in such rate bases.²⁹ Using this

²⁹ As explained in the Kolbe/Vitka Study, the event study used a value-weighted and an equally-weighted portfolio of eight "pure play" cable companies and tracked the cumulative return on the portfolios in the months before and
(continued...)

approach, Kolbe and Vitka determined that capitalized monopoly profits constitute less than 10 percent of the preregulation market value of cable assets.

The Kolbe/Vitka Study found, in particular, that there were two sharp drops in market value associated with dates that represent the market's recognition of regulation: a June-September 1992 fall and a February-April 1993 fall. The June-September 1992 fall corresponds to the passage of the Cable Act of 1992; the February-April 1993 falls corresponds to the FCC's adoption of the benchmark/price cap scheme. In both falls, equity values dropped roughly 20 percent which, as explained in the Kolbe/Vitka Study at 25-27, in turn represents a decline in asset values of under 10 percent.

Significantly, however, the price of the cable companies recovered immediately after each fall. While this return to prior price levels could have been influenced by a number of factors, it strongly suggests that the market overreacted in both cases. This market correction suggests, in fact, that the preregulation market values of cable systems reflected only a minimal amount of capitalized monopoly rents. The Kolbe/Vitka Study thus demonstrates that, while monopoly

²⁹(...continued)
after rate regulation. To control the influence of external events on the returns of the companies, Kolbe and Vitka tracked the portfolio of companies, rather than individual companies, and also arrived at a "beta" to measure the movements of the portfolio relative to the movements of the stock market.

rents cannot be assumed to account for more than 10 percent of preregulation market values, it is likely that these rents in fact amount to substantially less than 10 percent of those cable system values.

III. ONCE A CABLE SYSTEM'S INITIAL RATE BASE IS ESTABLISHED, THE COMMISSION SHOULD USE "TRENDED ORIGINAL COST" IN ORDER TO REPLICATE THE WORKINGS OF A COMPETITIVE MARKET

Establishing the initial value of a rate base is only the first step in a cost-of-service process. A second, and equally important, step is to determine how those assets should be valued on a "going-forward" basis. The challenge facing the Commission is how to do this in a manner that properly balances the interests of investors and consumers and does not send the wrong economic signals to the marketplace.³⁰ FCC policy should value the assets as they would be valued in a competitive environment so that prices, in turn, will replicate those that would exist under competition. Viacom suggests that the best way to do so is through the use of trended original cost ("TOC").³¹

³⁰ This is an especially important concern if the Commission's cost-of-service rules are to accommodate the congressional intent of spurring competition in cable services. To do so, they must provide for a method of valuing the cable rate base that results in correct economic signals and leads to economic levels of investment.

³¹ Under TOC, "original cost plant surviving additions are segregated by year of addition. These amounts are then
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As explained in the Kolbe/Vitka Study, TOC valuation is a straightforward and relatively simple adjustment to the traditional approach. Asset values are determined by adjusting the investment outstanding in any given year by the rate of inflation and adding to that amount any new investment made in that year. Net asset value is calculated by subtracting depreciation, which likewise is adjusted by inflation.

The NPRM, however, suggests applying the standard telephone industry approach to current and future rate base valuation -- that is, to value the rate base at the net historical cost and then depreciate it from that point forward. Whatever the merits of that approach in the telephone industry,³² the Kolbe/Vitka Study demonstrates its inadequacies for the cable industry.

As discussed in the Study, the fundamental difficulty with relying on historical cost is that prices will vary with

³¹(...continued)
trended using indices that recognize changes in the general price levels or in the costs of constructing plant facilities. The object is to restate the cost of installed facilities at current price levels." Accounting for Public Utilities, § 4.01 at 4.4.

³² The Commission, of course, concluded not long ago that the traditional form of rate base regulation, which depended upon depreciated historical cost, was no longer the optimal regulatory tool in the telephone industry. See Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd 2873 (1989).

the age of the "used and useful" assets, whereas competitive prices do not vary with the age of the assets employed.³³ Thus, historical cost cannot be assumed to produce consumer prices comparable to those prevailing in a competitive market. Instead, a historical cost will result in different, typically economically incorrect prices depending upon the age of the assets at the time of a rate proceeding.³⁴

This problem is exacerbated in an industry which, like cable, is characterized by dramatic peaks and valleys of investment. The end result will be rate "spikes" each time new capital is invested: the rate base jumps from a relatively small, fully depreciated figure to the higher amount reflecting the front end "loading" of the capital charges on the new investment.³⁵ This pricing pattern, with capital charges too high in early years and too low in later years, obviously does not replicate a competitive environment. More importantly, this "rate shock" would harm

³³ To illustrate, the Study observes that the market price of tomatoes does not vary with the age of the farmer's tractors. In contrast, the regulated price of electricity will be much lower if produced by a vintage 1960 plant than by an identical, but recently constructed, plant.

³⁴ See Kolbe/Vitka Study at 11-13.

³⁵ The vastly different "regulatory capital charges on otherwise identical electric plants built thirty years apart" was one of the causes of the rate shocks felt by electric customers in the 1980's. Kolbe/Vitka Study at 11.